DEBT MANAGEMENT

AN ESSENTIAL SKILL FOR INVESTORS

By specialist property accountant Stephen Fay ACA

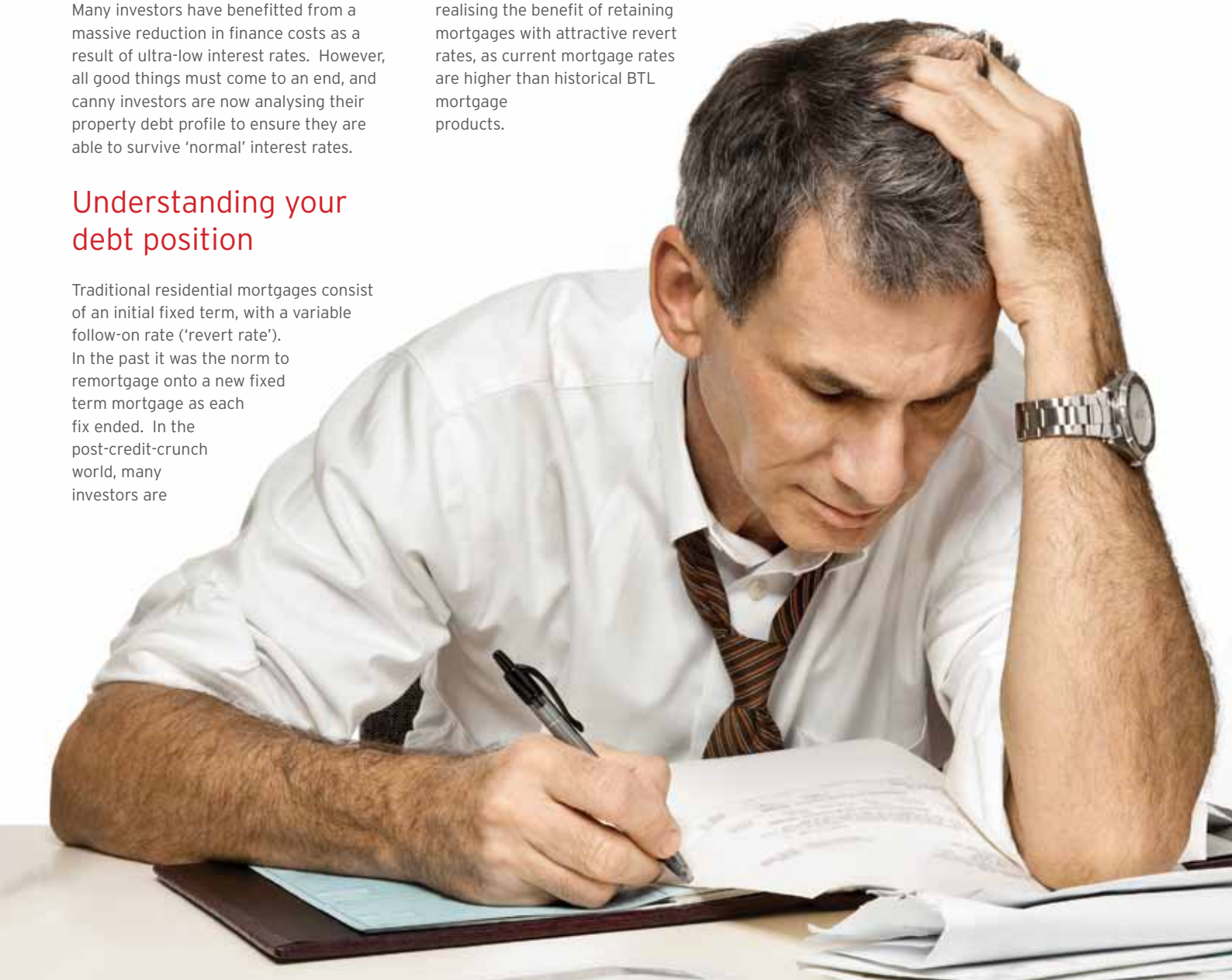
The vast majority of investors use debt to finance their properties and so get a better return on their own cash invested. This means that, for most investors, their most significant property cost is the interest on their borrowings. With portfolio investors often having mortgages and other borrowings with different banks, on different terms and rates, understanding their debt position and interest rate exposure is vital.

Our FREE 'Debt Manager Tool' is available to download from our website (www.fyldetaxaccountants.co.uk) to help investors model their own debt position and check their exposure to interest changes.

Many investors have benefitted from a massive reduction in finance costs as a result of ultra-low interest rates. However, all good things must come to an end, and canny investors are now analysing their property debt profile to ensure they are able to survive 'normal' interest rates.

Understanding your debt position

Traditional residential mortgages consist of an initial fixed term, with a variable follow-on rate ('revert rate'). In the past it was the norm to remortgage onto a new fixed term mortgage as each fix ended. In the post-credit-crunch world, many investors are realising the benefit of retaining mortgages with attractive revert rates, as current mortgage rates are higher than historical BTL mortgage products.



Most mortgage revert rates will be one of these three types.

BOE / LIBOR

'BOE' mortgages follow the rate set by the Bank of England (BOE), at a fixed-margin. For example, the mortgage rate may be 2% above the bank rate (currently 0.5%) to give a pay-rate of 2.5%.

LIBOR mortgages follow 'LIBOR' (the 'London Interbank Offered Rate'), which is effectively the rate at which banks lend money to each other. LIBOR is traditionally slightly higher than the BOE rate, often by around a half-percent.

BOE and LIBOR tracker mortgages are attractive where bank rates are expected to remain low. Lenders are obliged to peg their mortgage pay-rates to the terms of the mortgage agreement (although, some lenders have been able to break that contract, citing 'unprecedented conditions').

It's important to realise that LIBOR can rise quickly and substantially even if the BOE rate remains steady – for example, should a bank liquidity crisis be created as a result of the current Greek financial crisis. Since LIBOR is set within the banking world, not by a central bank, it is more volatile than the BOE rate.

Understanding at what margin your tracker mortgage operates (e.g. +2%), and which index (BOE or LIBOR) it tracks, is vital to understanding how your interest payments will change as BOE and LIBOR change. This means going back to your mortgage offers to check the revert-rate – many lenders favour LIBOR (e.g. Paragon, Kensington), others favour BOE (e.g. Mortgage Express, Bank of Ireland).

Lender Standard Variable Rate

Some lender revert rates do not track BOE or LIBOR, but instead are set by the lender themselves. This has meant that many investors have not benefitted from historically low base rates as lenders such as Accord and DHL have reduced their interest rates very little. These mortgages are often provided by Building Societies and can be less attractive than tracker mortgages as the rate payable is at the lender's sole discretion.

Portfolio analysis

Completing a 'portfolio review' to understand your debt profile, helps to understand your exposure to changes in interest rates. This can be completed by analysing borrowings by property and lender, and mortgage type and margin rate.

Multiplying these figures out, and allowing for different base and LIBOR rates, provides a simple 'stress test' to highlight how the portfolio copes with different interest rate scenarios.

Yield on debt

A key metric to calculate is the portfolio 'yield on debt'. This is the rental income as a % of borrowings. This allows a simple comparison between what the portfolio generates in income, versus what it costs in debt interest. There should be a healthy margin between these two percentage figures, to enable letting costs to be paid, with some 'spare capacity' to fund contingencies.

Using the debt analysis

The purpose of completing the debt analysis, is to understand how changes in interest rates affect rental profits. For example, an investor with a portfolio of Mortgage Express trackers at 1.75%+BOE will have a very different exposure to an investor with mainly BM Solutions 4.19%+BOE trackers. At a 5% BOE rate, each £100k of mortgage debt will cost £765 per month (BM Solutions) rather than £562 (Mortgage Express) - a difference of £2500 per year: and that is on just one mortgage.

It is often the case that one or two properties skew the figures if there are excessive borrowings on those properties, or the mortgage product is not particularly good.

Having completed the debt analysis, it is then time to 'stress-test' the portfolio using various base rates. For example, you may wish to use a medium-term BOE rate of 3% (to test the next 5 years if you feel base rates will remain below that level, as some commentators do), whereas for the long-term you may use a base rate of 5%.

Taking action

What action should be taken if the result of the debt analysis if a portfolio can't survive 'normal' interest rates?

1. Re-mortgage poor mortgages onto better deals – assuming there is sufficient equity, as the economy returns to normality, the mortgage market should improve, and better mortgages become available. It is vital to remain credit or thy to do this!

2. Sell off any properties with a poor yield and poor mortgage rate. Many investors are able to carry properties with below-par yields if these are financed with a particularly good mortgage. Problems arise where the yield and the mortgage are poor – a toxic combination.

3. Keep the mortgage - sell the property. Many mortgages are 'portable' and so can be transferred to another property – this can allow the disposal of a poor property, while retaining a good mortgage – so worth checking the mortgage offer.

4. Raise the income – has the rent kept pace with the market? Can the property be let on a multi-let basis? Could developing the property, or carrying out repairs, allow a higher rent to be charged – which often brings a far greater return than using the refurb funds to repay debt?

5. Is there maintenance works that can be done to 'future-proof' the property against future excessive repair bills? Could solar panels or better insulation help to make the property more attractive – and so reduce voids? Get creative to maximise the property potential.

6. Many investors have ploughed back much of their recent property 'super-profits' into paying off debt as they don't want to grow the portfolio size.

Once an adequate cash reserve has been built up, it may make sense to repay the highest-cost debts over time. With almost zero interest rates, returns on savings are often so low that earning a post-tax return higher than your highest mortgage interest rate may not be possible.

Summary

The leverage effect of using debt finance can greatly increase property investment profits.

However, it is vital for investors to understand how finance interest – usually their largest expense – will change as the interest rate environment changes. Fore-warned is fore-armed!

Visit our website (www.fyldetaxaccountants.co.uk) for our FREE Debt Manager Tool - to help you to plan and grow a sustainable & profitable portfolio – that will survive high as well as low interest rates.